MORE OF THE SAME

The Federal Reserve lowered the Fed Funds Rate again in October to the 1.50-1.75% range. It has indicated that it is still data dependent and may or may not lower again this year. The market is pricing in at least one more reduction later this year. The Fed has two mandates. The first is full employment. The unemployment rate is 3.5%, the lowest in fifty years. The second is to control inflation. Inflation is running slightly below the Fed target of 2.0%.

It has lowered rates to try to get the inflation rate to its target. This has not worked and there is a question as to whether it will work. Interest rates in Europe are negative in some countries and they are not seeing inflation rise. So why is this happening since it has worked in the past? Some of the reasons are demographics, high productivity, a global economy with global supply chains aided by technology, and low price labor cost around the world. All of these are interconnected. Many economists and Fed officials think this will be the situation for a long time going forward.

JP Morgan Asset Management

JP Morgan Asset Management has just released its “Long-Term Capital Market Assumptions”. Their analysis reveals the need for new portfolio construction tactics in a low-rate world. They say investors must re-think “safe havens” in their portfolios now that bonds simply can’t offer the same combination of portfolio protection and positive income that they have in the past. John Bilton, Head of Global Multi-Asset Strategy, and Dr. David Kelly, Chief Global Strategist, appeared on Bloomberg on November 6, 2019 to explain. They said that projections for the 10-15 year investment horizon remain relatively modest with aging population a key headwind, while a technology-driven boost to productivity represents the main upside risk.

Real global growth is expected to average 2.3% per year over the next 10-15 years. Global inflation projections are little changed at 2.2% per year. Monetary policy is expected to remain extremely accommodative. A 60/40 U.S. stock-bond portfolio return is expected to average 5.4% per year.

The following are some key points made in the Assumptions:

Equities: Average global equity return forecasts over the next 10-15 years rise 50 bps to 6.5% in U.S. dollar terms.

Fixed Income: Anticipating continued central bank dovishness, we shift our equilibrium interest rates lower across major G4 markets and extend the time horizon over which we expect rate normalization.

Alternatives: The 10-15 year aggregate private equity return forecast has been raised 55 bps to 8.80%. Private equity continues to be attractive to those investors looking for return uplift, as well as those seeking more specific exposure to technology themes. This year we forecast that core U.S. real estate returns, levered, net of fees, will average 5.80% over the next 10-15 years. Forecast returns from global real assets and infrastructure have held up remarkably well, and

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given the resilience of their cash flows they may even act as a proxy for duration in portfolio with limited short run liquidity demands. Manager selection remains the primary determinant of returns across alternatives.

Currency Exchange Rates: We expect the U.S. dollar (USD) to depreciate over our forecast horizon vs. other major global currencies. The dollar's overvaluation could compromise some of the currency's appeal as a potential safe haven asset.

At Monroe Vos we have recommended alternative investments in real estate, mezzanine financing private equity invested in financial firms, and private equity buying secondary fund limited partners interest at a steep discount since 2008 to replace fixed income investments.

As you recall the Fed raised interest rates in the fourth quarter of 2018 and said it was on auto-pilot to a 3.50% Fed Funds rate. The S&P 500 was down 19% peak-to-trough in late 2018. In January 2019, the Fed pivoted and has lowered rates this year causing the S&P 500 to rebound resulting in an S&P 500 return for the year ending 9-30-2019 of 4.25%. The Barclays' Aggregate Bond Index return was 10.30% over the same period. We recommended lowering asset allocation from 60% stocks to 40% and raising bonds/alternatives from 40% to 60% on October 10, 2018. This resulted in our clients avoiding the drop in the market from the middle of October 2018 to the end of the year in 20% of their assets. The 20% increase in bonds outperformed the stock market during this period. We have continued to recommend this allocation in 2019. We view a 40/60 allocation of stocks to bonds to be a neutral allocation and appropriate given the volatility we are experiencing. The trade war, Brexit, negative interest rates in Europe and other parts of the world, a slowing global economy, unrest in the Middle East, a slowing U.S. economy, UBER, LYFT and WeWork and a highly valued stock market are all indications that we are close to the end of the decade long bull market. The positives are the low unemployment rate (3.5%), consumer sentiment, consumer spending and low interest rates, allowing assets to rise in value. We believe the stock market has more room to rise because interest rates are so low. If the Fed continues to lower rates, the stock bubble will continue to grow until at some point it bursts.

Hoisington

The following commentary is from the Hoisington Investment Management Company "Quarterly Review and Outlook Third Quarter 2019":

Thirty-year Treasury bonds reached a new record low yield in the third quarter of 2019 at 1.90% eclipsing the previous record low of 2.09% set in August of 2016. No cataclysmic events, such as a fear of systemic banking collapse or some immediate slump in economic activity, created the new low yield in risk-free long-term yields. Certainly, concerns on trade and economic weakness overseas, and a reversal in Fed policy toward ease, could be cited as the proximate cause yet these problems were well known for a considerable time, since early in the year Fed Chair Powell had introduced the possibility of a policy rate reduction in 2019.

The move in rates from 3.02% at the start of 2019 to 1.90% in August 2019 can be attributed to a shift in inflationary expectations which were formed as a result of the lagged impact of Federal Reserve policy actions. In 2015, the Fed initiated the first of nine 25 basis point increases in the

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federal funds rate, thus the "price" of credit rose. However, there are also quantity effects as Fed actions simultaneously shrunk the monetary base and the excess reserves of the depository institutions by 21% and 50%, respectively, as of the final week of September 2019, from their 2014 peaks. The Nobel Prize winning economist, Dr. Milton Friedman, explained at length the delayed impact of Fed policy actions upon economic activity. He postulated that a monetary tightening via the raising of policy rates would eventually result in a lower market level of interest rates due to falling expectations for both inflation and real growth.

For Friedman, raising of the policy rate would temporarily move market rates higher in the short run (liquidity effect), but that circumstance would slow growth (income effect), and thus lower inflation (price effect). In the most recent episode this pattern is visible. The more restrictive monetary conditions slowed housing and construction activities noticeably. Additionally, auto sales peaked more than a year ago, displaying its sensitivity to higher rates. Core capital goods orders and the backlog of unfilled orders have fallen below the year ago levels. These sectors and others reacted poorly to a higher cost of money and consequently labor markets were adversely affected.

The global over indebtedness has clearly restrained growth, and therefore has had a profound disinflationary impact on every major economic sector of the world. This fact, coupled with an overzealous U.S. Central Bank have created the conditions for an economic contraction in the U.S. and abroad. This has also created a worldwide decline in inflation and inflationary expectations. It is therefore unsurprising that record lows in long term interest rates have been established in all major economic regions. A quick and dramatic shift toward greater accommodation by the Fed could begin to shift momentum from contraction toward expansion. However, policy lags are long and slow to develop, therefore despite the remarkable decline in long term yields this year, we are maintaining our long duration holdings. A shift towards shorter duration portfolios would be appropriate when the forward-looking indicators of expansion, in the U.S. and abroad, begin to appear.

FactSet

FactSet Earnings Insight publishes its predictions based on what Wall Street analysts are estimating for economy and revenue growth for the next four quarters for the S&P 500. Please see the table below:

Quarter	Current Economy Estimate	Current Revenue Estimate
3rd Qtr 2019	-4.7%	+2.6%
4th Qtr 2019	+1.5%	+4.0%
1st Qtr 2020	+6.7%	+4.8%
2nd Qtr 2020	+7.7%	+5.2%
Calendar 2020	+10.4%	+5.3%

It should be noted that analysts have lowered earnings estimates for S&P 500 stocks for over one year now. This has resulted in companies beating estimates even though their earnings are lower than the prior year, resulting in P/E expansion. This cannot continue forever.

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Conflicts of Interest and Other Items of Interest

From an article in the *Wall Street Journal* dated October 5-6, 2019 by Jason Zweig:

"The Hidden Cost of Free Trading"

Freedom isn't free and free trades aren't either. Charles Schwab Corp. shook the brokerage industry this week when it said it will cut commissions to zero on Oct. 7. Schwab's move, which followed a similar cut by Interactive Brokers Group Inc. and has already been matched by rivals TD Ameritrade Holding Corp. and E*Trade Financial Corp., is likely to be copied by other big brokers.

You no longer will pay a few bucks in commissions to buy or sell a security at these firms. But Schwab and other brokerage firms are in business to make money, and one way they often do that is by milking clients' cash. When you trade for free, you still pay – at a different tollbooth.

In fact, the term "brokerage" is becoming a misnomer. Firms like Schwab are more like banks than brokers. Commissions amounted to less than 7% of Schwab's total net revenues in 2018; they were 14% in 2014.

Why take that to zero? Eradicating commissions is the logical culmination of what Schwab has been doing ever since former newsletter publisher Charles Schwab founded the company in 1973: driving down the costs of investing.

Schwab can offer such cheap options partly because of how it handles investors' cash. The firm automatically sweeps idle cash not into money-market mutual funds or other assets that could yield about 2% at today's rates, but into its own bank, which pays peanuts.

As is typical in the brokerage business, Schwab puts clients' un-invested cash – say, a dividend or interest payment – into what's called a sweep account. It's your money, but how much it earns isn't' always up to you.

You might be able to earn better rates in the first half of 2019, Schwab clients moved $58 billion into money-market funds and other higher-yielding choices. But most don't bother. Even worse, many don't have a choice because they hold accounts that are required to keep cash at low yields in Schwab's own bank. That has been a bonanza for the firm.

Schwab pushed $11.8 billion out of higher-yielding money-market funds into deposits at its own bank in the first half of 2019, according to the company. As of June 30, deposits at Schwab's bank totaled $208 billion. This week, clients were earning between 0.12% and 0.55% on those balances.

When clients invest in Schwab Intelligent Portfolios, its roboadvisory service that offers preselected baskets of ETFs, between 6% and 30% of the money goes into cash. Schwab doesn't use money-market funds or short-term Treasury debt, which could earn nearly 2% at recent rates.

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Instead, it shunts the cash into Charles Schwab Bank, which currently pays 0.55% on the money—and then turns around and lends it out at roughly 2%.

With $41 billion in assets, those portfolios hold about $4 billion in cash. Conservatively assuming Schwab nets about 1.5% by lending out that money through its bank, the firm is making roughly $60 million a year on it. The clients, meanwhile, are earning less than $25 million.

Schwab discloses all this. The rate it pays on clients' cash "may be higher or lower than...on comparable deposit accounts at other banks," warns a disclosure from Schwab Intelligent Portfolios. "Schwab does not intend to negotiate for rates that seek to compete with" other cash options, adds the disclosure.

Furthermore, the document states, if you need to withdraw money from your Schwab Intelligent Portfolios account, the firm may sell some of your ETFs—potentially triggering a taxable capital gain—to restore your cash balance to its required level.

Fewer than 1% of clients hold such accounts at a 30% cash allocation, says a Schwab spokeswoman, and the average cash holding in the program is about 10%. The sale of some ETFs to return the cash allocation to its required level is no different from what happens after withdrawals from any other account that has predetermined targets for its holdings, she says.

Still, according to David Goldstone of Backend Benchmarking, a research firm in Martinsville, N.J., that tracks automated online investing services, no other roboadvisor requires clients to hold even as much as 10% in low-yielding cash.

How does Schwab reconcile forcing its clients to invest in its own bank at below-market rates with its duty to put clients' interests ahead of its own?

"We take our fiduciary duty very seriously," the company said in a statement. "Our clients who invest through Schwab Intelligent Portfolios understand the cash that will be in their portfolio before they decide to invest."

When I asked the Securities and Exchange Commission if it had any comment on how advisers treat investors' cash, Chairman Jay Clayton responded: "These are exactly the types of questions investors should be asking."

Conclusion

The Fed raised rates in late 2018 and then reversed rates in 2019, creating huge volatility in the stock and bond markets. Chairman Powell attempts to provide transparency in the Fed's thinking at news conferences. The media analyzes every word and phrase he utters in these news conferences. He misspeaks often and creates volatility. We are in favor of a return of the Allen Greenspan era where the press guessed what the Fed was going to do based on the size of Mr. Greenspan's briefcase. Too much information is not always good.

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The trade war between the U.S. and China has created volatility as well. They seem to be close to an agreement and then they aren't. We believe that some small agreement will happen but it will not be significant. President' Trump needs a Phase 1 agreement to help his chances of getting reelected. The Chinese on the other hand want to see what happens in the 2020 election. We think the trade war will last for years. The Chinese government is brutal and thinks in terms of decades, not years. Look what is happening in Hong Kong.

J.P. Morgan Asset Management and others like them predict slow global growth for the next 10-15 years and a 5.4% per year average return for the stock market. They predict bond yields to stay low as does Hoisington. In this environment a percentage in alternative assets may be the best solution to achieve return objectives. This does not mean hedge funds. They are too expensive and have not delivered the expected performance.

Jamison Monroe
Chairman & CEO
Director of Consulting

Monroe Vos has over $5 billion under advisement for 97 clients. Recent rankings are as follows:

- The 2nd largest independent registered investment advisor ("RIA") in Texas
- The 8th largest independent RIA in the Southeast
- 54th largest independent RIA in the United States

As reported by *Financial Advisor* magazine in July 2019

We appreciate your relationship. If you know someone else that can use our services, please refer them to us.

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